

**ROMANIA**

**DETERMINING YOUR DEBT  
CARRYING CAPACITY**

**A GUIDE FOR LOCAL  
OFFICIALS**

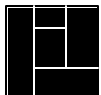
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## **PURPOSE OF THIS GUIDE**

### ***What is the purpose of this guide?***

This guide presents concepts and techniques to assist local elected officials and their staff in making sound financial management decisions about how much they can afford to borrow to finance local investment projects.

The guide looks at three key issues:

- 8 Why is it important to determine your debt carrying capacity before making a decision to borrow?
- 8 What are the key steps in preparing the analysis of your debt carrying capacity?
- 8 What are the key steps in monitoring repayment of outstanding loans?

### ***Who should read this guide?***

This is a guide primarily for local staff who are responsible for the finances of a local or judet council that is considering whether to borrow to finance capital investments. They should read this guide before making a recommendation whether and how much to borrow.

Local elected officials who will be making the decision on borrowing also may want to review the basic concepts and techniques presented in this guide.

### ***What should the reader hope to obtain from this guide?***

This guide provides an in-depth review of the concepts, analytical techniques and procedures involved in determining how much a local or judet council can afford to borrow to finance local investment projects. After completing the guide, the reader should know how to prepare a debt carrying capacity analysis. The reader also should have an improved understanding of the financial risks that arise in the process of borrowing and of the techniques that are useful in addressing them.

### ***What are the limitations of the guide?***

This guide focuses on borrowing as a way of financing local investments. There are other possible options closely related to borrowing, such as bond or private equity financing, that are not discussed in this guide. A local government interested in exploring such options will find that many of the concepts, analytical

techniques and procedures described in this document are useful and relevant. However, the reader should seek additional guidance specific to the type of financing involved.



### ***Why is this guide necessary?***

As part of the process of decentralization in Romania that began in 1990, local and judet councils have become increasingly responsible for addressing the needs of the local communities in the country. The reforms to the system of local finances enacted in 1998 reinforced the trend toward greater autonomy. These reforms gave local authorities greater control over their own taxes and fees, as well as direct access to a share of the national wage tax. The reforms also gave the local and judet councils full authority to decide how to spend and invest these resources. These changes have increased the importance of making sound financial decisions at the local level.

Local officials face difficult challenges in the management of their finances. The demands for new expenditures have grown. These include capital investments to improve, expand or create new infrastructure to provide better services and to meet new environmental standards. At the same time, the difficult national fiscal and economic situation has limited the growth of resources available to meet local service and investment needs. Faced with competing demands for scarce resources, local and judet councils are turning progressively to borrowing as a way of financing priority investment projects. Financing provided on commercial terms is becoming an important complement to more traditional funding from State and local budgets.

Learning how to borrow prudently and successfully presents new challenges that require understanding of new concepts and analytical techniques. As part of that process, this guide will help local officials determine how much they can realistically afford to borrow and repay in future years.

## PART I

### BASIC CONCEPTS AND TERMS

***What should I know about the finances of the local or judet council before deciding whether and how much to borrow?***

- 8 The current financial condition of the local or judet council
- 8 The future debt carrying capacity of the local or judet council

#### **Key Concepts and Terms Defined in Part I**

- Current financial condition
- Annual debt service
- Debt carrying capacity

***What determines the financial condition of the local or judet council?***

In its simplest form, the ability to pay for all expenditures with the financial resources that are available determines the ***financial condition*** of a local or judet council. This analysis looks at questions such as:

- 8 Are total revenues sufficient to pay for total expenditures?
- 8 Are revenues from local taxes, shared wage taxes and the equalization grants provided from the State budget sufficient to pay for all expenditures other than investments?

The analysis of the ***current*** financial condition is concerned not only with the most recent year, but also with the results in the immediate past. Thus, it will look at questions such as:

- 8 What are the trends in recent years in revenues and expenditures?
- 8 How fast have revenues been growing relative to expenditures?



## 8 What are the factors that have determined the trends in revenues and expenditures?

Note that all the factors are concerned with the relation between revenues and expenditures in the current and previous years. While it may appear that this is information that you already know, this guide will use concepts such as **recurring or current revenues**, **operating expenditures** and **net operating results** that will provide new insights regarding your financial condition that are important in determining how much you can afford to borrow.

### ***What is the annual debt service?***

A typical loan contract will require that you make periodic payments of principal and interest until you have repaid the full amount you borrowed. Since you budget on a yearly basis, you will be most interested in the sum of all the payments you must make each year. This is the **annual debt service**. How much you pay each year will depend on the terms included in the loan contract. Among the most important terms are the time you have to repay the loan and the interest rate.

Figure 1 provides an example of the annual debt service on a typical loan.

<b>Figure 1</b>				
Amount of the loan in thousands of lei – 7,500,000				
	Years to pay – 3			Interest rate – 50%
	Year 1	Year 2	Year 3	Total
<b>Annual debt service</b>	5,328,947	5,328,947	5,328,947	15,986,842
Of which you will pay in:				
Principal	1,578,947	2,368,421	3,552,632	7,500,000
Interest	3,750,000	2,960,526	1,776,315	8,486,842

Note that the annual debt service remains the same in each of the three years. This is typically the case. Note also that the amount you pay in principal goes up each year. The reverse is true for interest payments because each year you are paying interest only on the portion of the loan that you still owe. Finally, note

that the total interest payments after three years are greater than the amount you borrowed. This will not always be true. Generally, the higher the interest rate and longer the time to repay the loan, the more you will pay in interest. As you can see, borrowing can be costly.

***What is debt carrying capacity and why should I analyze it before making a decision whether and how much to borrow?***

When you sign a loan contract you agree to make annual debt service payments over several years. You will need to make sure that you have the funds each year to make these payments. The safest and most prudent approach is to rely only on those funds that you know will be available. These include the funds you obtain from local taxes, shared wage taxes and the equalization grants provided from the State budget, in other words, your recurring or current revenues.

In its simplest expression, your **debt carrying capacity** is determined by how much you can set aside from your recurring revenues each year over the next several years in order to make annual debt service payments.

**A note of caution** The Law on Local Public Finances provides that the amount of interest and principle you pay on all outstanding loans of your local or judet council must be 20 percent or less of your current revenues

***What factors affect my debt carrying capacity?***

The key factors are:

- 8 Your willingness and ability to limit funding for services for your community so that you can pay for investments and for credit to finance those investments

Remember that you should plan to pay the annual debt service from your recurring revenues. These are the same revenues that pay for the services that you provide to your community, such as maintenance of streets, schools and parks. These also are the revenues you use to pay your own administrative costs, such as the salaries of your employees.

- 8 Your willingness and ability to accept risk



There is no simple mathematical formula that will calculate your debt carrying capacity. This guide describes quantitative methods that can help you in the process. However, eventually you will have to make difficult choices that depend largely on your judgement. These choices always will be present when you make a decision about a loan. It is important to make sure you are aware of the choices and agree with the decisions before proceeding with any loan.

***Does my debt carrying capacity determine how much we can afford to invest in our community?***

Not necessarily. The debt carrying capacity tells you how much your local or judet council can borrow to pay for investments while relying exclusively on its own revenues. Often, it will be the case that one or more of the projects you have in mind will generate their own revenues once they have been completed. This is the case, for example, of a water system. Once it has been completed, the consumers will pay a fee for the water they consume. The income from these fees paid by the consumers also can be used to pay the debt service on a loan. This loan would provide additional funding to pay for investments. In this case, the borrower would be the *regia* or company that will implement the project.

The ability of a specific investment project to generate its own revenues to pay for debt service on a loan is determined by **project financial analysis**. This type of analysis is not the same as the debt carrying capacity analysis described in this guide.

**A note of caution:** If the local or judet council is not the borrower, it might seem that this does not affect your debt carrying capacity. However, the lender or an investor may ask the local or judet council to guarantee the loan provided to the company or regia that will implement the project and be the actual borrower. This guarantee will reduce your debt carrying capacity in one of several ways. Lenders will take the guarantee into account when they decide how much they think you can afford to borrow to finance other investments. Also, if the borrower fails to pay and your guarantee becomes effective, this will count against the 20% limit established by law.

***What are the key steps in preparing an analysis of debt carrying capacity?***

8 Reorganize the financial data

- 8 Analyze your current financial condition
- 8 Prepare alternative projections of your future financial condition
- 8 Analyze your investment needs and priorities
- 8 Decide whether and how much to borrow

## PART II

### REORGANIZE THE FINANCIAL DATA

#### Concepts and Terms Defined in Part II

- Other sources of financing for operating expenditures
- Other sources of financing for capital expenditures

Currently, local and judets councils present the overall financial results in the format shown in Table 1. It first lists all the sources of funds, then all the expenditures, arranged by key sectors or chapters. As we will see below, this presentation does not provide the information that local officials need to determine their financial condition and debt carrying capacity. Fortunately, all the information they will need is available to them. They simply need to rearrange the data as shown in Table 2.

The key differences between the two tables are as follows:

- 8 In Table 2 the revenues have been separated into three groups labeled current revenues, ***other sources of financing for current expenditures*** and ***other sources of financing for capital expenditures***. Table 3, Reorganizing Your Revenues by Category, shows how to place all the sources of funds available to local and judet councils at this time in one of these three groups.
- 8 In Table 2 expenditures have been separated into two groups labeled operating and capital expenditures. It is quite easy to construct these two groups using data as presented in Annex 14 of the annual financial statements.
- 8 There are two new partial results in Table 2 labeled *operating surplus (deficit) before debt service* and *net operating surplus (deficit)*. The overall surplus (deficit), as currently shown, remains at the bottom of the table.

#### Technical Note

**Other sources of financing** for **operating** and **capital expenditures** include those funds that may or may not be available to you in a given year. For example, the local regia may not always show a profit in which you would share. Or, you may not sell local property or obtain a loan in every year. Treating them as a separate category in the analysis of your financial condition is a sound and prudent financial practice. This does not mean, however, that you may not rely on these to tide you over a difficult period when there is an unusual or unexpected decrease in revenues or increase in expenditures.

The numbers in Tables 1 and 2 are the same, only organized differently. For example:

	<i>Table 1</i> 1994		<i>Table 2</i> 1994
State Subsidies	114,078	Other Sources of financing for capital expenditures – from other sources	114,078
Shared national tax revenues	2,841,836	Shared national tax revenues	2,841,836
Own Revenues	2,502,763	Local taxes and fees	1,167,342
		Other sources – operating	647,347
		Other sources capital – own	688,074
		Total	2,502,763

With the data as shown in Table 2, you are now ready to begin the process of analyzing your current financial conditions and estimating your debt carrying capacity.

**Table 1**  
**Statement of Income and Expenditures (Current Version)**

	1994	1995	1996	1997	1998
TOTAL REVENUES	5,458,677	15,128,624	27,217,531	62,286,920	75,519,015
Own Revenues	2,502,763	8,595,382	10,733,176	17,381,612	32,700,300
Shared National Tax Revenues	2,841,836	6,097,192	9,643,488	21,458,505	18,905,190
State Subsidies	114,078	436,050	6,840,867	23,446,803	23,913,525
Donations	0	0	0	0	0
Loan Proceeds	0	0	0	0	0
TOTAL EXPENDITURES	5,352,311	15,113,410	26,927,600	62,214,114	74,937,615
Of which:					
– General Administration	263,891	657,360	1,182,933	2,991,638	5,478,726
– Education	0	2,326,357	3,550,050	6,665,223	10,465,200
– Health	2,726,494	4,015,148	6,142,711	10,776,733	996,132
– Culture & Sports	0	24,322	15,392	12,209	41,667
– Social Assistance	394,375	730,090	985,352	1,885,178	3,099,831
– Public Works & Housing	1,953,163	7,240,199	13,682,272	36,200,953	52,148,673
– Transportation & Communication	14,083	116,498	1,276,412	3,624,060	2,688,006
– Other Economic Activities	0	0	0	0	0
– Other Activities	305	3,435	92,478	58,120	19,380
Set Aside for Reserves	53,184	7,607	289,931	72,806	581,400



Loan Payments (Interest/Principal)	0	0	0	0	0
Surplus (Deficit)	53,183	7,608	0	0	0
Distribution of Surplus	53,183	7,608	0	0	0



**Table 2**  
**Statement of Income and Expenditures (Modified Version)**

	1994	1995	1996	1997	1998
<b>Current Revenues Total</b>	4,009,177	13,404,320	24,265,947	56,221,661	65,594,159
Of which:					
– Local Taxes and Fees	1,167,342	7,307,128	9,209,250	15,189,356	28,104,945
– Transfers from the State budget (equalization grants new law)	2,841,836	6,097,192	9,643,488	21,458,505	18,905,190
– State Operating Subsidies	0	0	5,413,209	19,573,800	18,584,025
– Shared National Tax Revenues	n/a	n/a	n/a	n/a	n/a
<b>Operating Expenditures Total</b>	5,218,853	11,952,238	24,007,793	55,506,142	65,348,391
Of which:					
– General Administration	263,891	535,843	1,105,413	2,701,249	5,211,282
– Education	0	2,326,357	3,550,050	6,665,223	10,465,200
– Health	2,726,494	4,015,148	6,142,711	10,776,733	996,132
– Culture & Sports	0	24,322	15,392	12,209	41,667
– Social Assistance	394,375	720,530	985,352	1,885,178	3,099,831
– Public Works & Housing	1,833,788	4,327,571	11,112,047	30,117,655	42,832,707
– Transportation & Communication	0	0	1,004,350	3,333,360	2,688,006
– Other Economic Activities	0	0	0	0	0
– Other Activities	305	2,466	92,478	14,535	13,566

	1994	1995	1996	1997	1998
<b>Operating Surplus (Deficit) – Before Debt Service</b>	(1,209,675 )	1,452,082	258,154	715,519	245,768
Net Operating Surplus (Deficit) as a percent of total current revenues	-30.2%	10.8%	1.1%	1.3%	0.4%
<b>Total Debt Service</b>	0	0	0	0	0
<i>Interest Payments Current Debt</i>	0	0	0	0	0
<i>Principal Payments</i>	0	0	0	0	0



	1994	1995	1996	1997	1998
<b>Other Sources of Financing for Current Expenditures</b>	647,347	468,338	694,822	1,450,117	3,858,237
Of which:					
– Various Local Extraordinary Income	647,347	468,338	694,822	1,450,117	3,858,237
<b>Net Operating Surplus (Deficit)</b>	(562,328)	1,920,420	952,977	2,165,637	4,104,006
<b>Other Sources of Financing for Capital Expenditures</b>	802,153	1,255,965	2,256,761	4,615,142	6,066,618
Of which:					
– From Own Sources	688,074	819,915	829,104	742,139	737,118
– From Other Sources	114,078	436,050	1,427,658	3,873,003	5,329,500
<b>Total Funds Available for Investments</b>	239,825	3,176,386	3,209,738	6,780,778	10,170,624
<b>Capital Expenditures Total by Chapter</b>	133,458	3,161,172	2,919,807	6,707,972	9,589,224
– General Administration	0	121,516	77,520	290,389	267,444
– Education	0	0	0	0	0
– Health	0	0	0	0	0
– Culture & Sports	0	0	0	0	0
– Social Assistance	0	9,560	0	0	0
– Public Works & Housing	119,375	2,912,628	2,570,225	6,083,299	9,315,966
– Transportation & Communication	14,083	116,498	272,062	290,700	0
– Other Economic Activities	0	0	0	0	0
– Other Investments	0	969	0	43,585	5,814
<b>Overall Surplus (Deficit)</b>	106,366	15,214	289,931	72,806	581,400
<b>Set Aside for Reserves</b>	53,184	7,607	289,931	72,806	581,400

	1994	1995	1996	1997	1998
<b>Distribution of Surplus to Others</b>	53,183	7,608	0	0	0
<b>Total Other Payments</b>	106,366	15,214	289,931	72,806	581,400
<b>Net Transfer To (From) Accumulated Surplus</b>	0	0	0	0	0

**Table 3**  
**Reorganizing Your Revenues by Category**

<b>Code</b>	<b>Category/Sub Category</b>
	<b>Recurring Revenues</b> of which:
n/a	Local Taxes and Fees
n/a	Shared National Salary Tax Revenues
n/a	State Operating Subsidies
	<b>Local Taxes and Fees</b> of which:
01.02.	Taxes on Profits of Regii
03.02.	Taxes and Fees on Individuals
04.02.	Fees for Use of State Property
05.02.	Corporate Property Tax
06.02.	Corporate Vehicle Fees
07.02.	Tax on Revenues from Agriculture
08.02.	Other Direct Taxes
15.02.	Entertainment Fees
17.02.	Other Indirect Taxes
	<b>Shared National Tax Revenues</b> of which:
34.02.	Shared National Salary Tax Revenues
	<b>State Operating Subsidies</b> of which:
37.02.01	Subsidies for Social Assistance, Heating & Public Transport
	<b>Non-Recurring Revenues</b> of which:
n/a	Non-Recurring Local Operating Revenues
n/a	Local Capital Revenues
n/a	Other Capital Revenues

**Non-Recurring Local Operating Revenues** of which:



20.02.	Distribution from Profits of Regii
21.02.	Revenues from Public Institutions
22.02.	Other Various Revenues
40.02.	Donations

**Local Capital Revenues** of which:

30.02.	Proceeds from the Sale of Public Property & Housing
45.02.	Proceeds of Short-term Loans

**Other Capital Revenues** of which:

37.02.02	State Capital Investment Subsidies
37.02.03	Capital Investment Subsidies from External Loans
46.02.	Proceeds of Loans from Revolving Funds

## PART III

### ANALYZE YOUR CURRENT FINANCIAL CONDITION

Using the reorganized financial data for your local or judet council you can look at the key financial results of the local or judet council.

#### Key Concepts and Terms Defined in Part III

- Net operating results
- Operating expenditures
- Current or recurring revenues
- Nominal and real values

The single most important measure of your financial condition are the ***net operating results*** of the local or judet council. You calculate this by subtracting total ***operating expenditures*** from total ***recurring or current revenues***. The ***operating expenditures*** include what you pay for the services that you provide to your community, such as maintenance of streets, schools and parks, as well as your own administrative costs, such as the salaries of your employees. In Romania today (in 1999) the ***recurring or current revenues*** include the funds you obtain from local taxes, shared wage taxes and the equalization grants provided from the State budget.

The net operating results may include:

- A net operating surplus when recurring revenues are greater than operating expenditures
- A net operating deficit when operating expenditures are greater than recurring revenues

This is a significant result. Should the local or judet council want to enter into a loan, the operating surplus will be the amount available to pay the ***annual debt service***. This will largely determine the maximum amount you can borrow.



**A note of caution** A local or judet council that has a current net operating deficit has no free recurring revenues available for debt service. It should not consider entering into any new loans until it has taken steps to identify and address the causes of the problem.

There are other measures of local financial condition. The following discussion looks at some of the most typical measures used in this type of analysis. The best course of action is to use more than one of them, if not all. Each one provides unique insights.

In each case, there is an example of the type of table you might want to construct. There also is a short discussion of what to look for in the numbers. Note that all the tables look at the current and most recent years. The data in all cases is taken from Tables 1 and 2. Part II of this guide.

### ***Overall results, that is, total revenues minus total expenditures***

#### **Sample Table:**

	1995	1996	1997	1998
	(Thousands of Lei)			
Total Revenues	15,128,624	27,217,531	62,286,920	75,519,015
Total Expenditures	15,113,410	26,927,600	62,214,114	74,937,615
<i>Overall Surplus (Deficit)</i>	<i>15,214</i>	<i>289,931</i>	<i>72,806</i>	<i>581,400</i>

Comments: These are the results as you are accustomed to looking at them. They do not tell you much. In the example, the numbers show that the overall results have fluctuated from year to year, with no apparent pattern. The table also shows that the local or judet council has kept total expenditures below the level of total revenues. This is positive sign because in the past local and judet councils had little incentive to generate a surplus.

### ***Net operating results, that is, recurring or current revenues minus operating expenditures***

**Sample Table:**

	1995	1996	1997	1998
	(Thousands of Lei)			
Current Revenues	13,404,320	24,265,947	56,221,661	65,594,159
Operating Expenditures	11,952,238	24,007,793	55,506,142	65,348,391
<i>Net Operating Surplus (Deficit)</i>	<i>1,452,082</i>	<i>258,154</i>	<i>715,519</i>	<i>245,768</i>

Comments: This is the most significant single indicator of your financial condition and of your ability to borrow. Remember that the net operating results show the amount of current revenues that are available to pay the annual debt service on loans. This number should be positive in every year. If it is not, particularly in the current year, or if there is a trend of diminishing surpluses, this is sign that operating expenditures may be too high for the level of current revenues. This is a situation that would need to be analyzed. The causes should be identified and the problem addressed.

***Trends in current revenues, that is, the change in value of revenues in key categories*****Sample Table (version A):**

	1995	1996	1997	1998
	(Thousands of Lei)			
Local Taxes and Fees	7,307,128	9,209,250	15,189,356	28,104,945
Transfers from the State	6,097,192	9,643,488	21,458,505	18,905,190
State Operating Subsidies	0	5,413,209	19,573,800	18,584,025
<i>Total Current Revenues</i>	<i>13,404,320</i>	<i>24,265,947</i>	<i>56,221,661</i>	<i>65,594,160</i>

**Sample Table (version B):**

	1995	1996	1997	1998
	(Thousands of Lei)			



Local Taxes and Fees	54.5%	38.0%	27.0%	42.8%
Transfers from the State	45.5%	39.7%	38.2%	28.8%
State Operating Subsidies	0.0%	22.3%	34.8%	28.3%
<i>Total Current Revenues</i>	<i>100.0%</i>	<i>100.0%</i>	<i>100.0%</i>	<i>100.0%</i>

Comments: This table shows how the composition of current revenues has changed over the years. Two of the three sources of revenues come from the State budget. This means that the local and judet councils have no say in determining how much they will receive from these sources. A growing reliance on these sources would mean that the local or judet council has less control over the total value of recurring revenues. Note that the table that shows the percentage share of each category is easier to interpret. In the example, local taxes and fees decline as a percent of total recurring revenues through 1997. This would not be a positive sign. However, the share increases in 1998. This is a positive sign. It shows the effect of the initial reforms in the Law on Local Taxes approved in 1997.

***Trends in operating expenditures, that is, the change in value of the expenditures in key categories***

This analysis has more variations than the others. It is possible to look at operating expenditures by chapter, that is, by purpose of the expenditure, as in general administration or public works and housing. It also is possible to look at the type of expenditure, that is, personnel, materials and services or transfers. Both are useful and relevant. The data in Table 2 only shows expenditures by chapter, so that is the only sample table shown below. For sake of brevity, the sample tables only look at trends in three chapters. Obviously, the full analysis would look at all the chapters.

**Sample Table (version A):**

	1995	1996	1997	1998
	(Thousands of Lei)			
General Administration	535,843	1,105,413	2,701,249	5,211,282
Public Works and Housing	4,327,571	11,112,047	30,117,655	42,832,707

Transportation	0	1,004,350	3,333,360	2,688,006
<i>Operating Expenditures</i>	<i>11,952,238</i>	<i>24,007,793</i>	<i>55,506,142</i>	<i>65,348,391</i>

**Sample Table (version B):**

	1995	1996	1997	1998
	(Thousands of Lei)			
General Administration	4.5%	4.6%	4.9%	8.0%
Public Works and Housing	36.2%	46.3%	54.3%	65.5%
Transportation	0.0%	4.2%	6.0%	4.1%
<i>Total Operating Expenditures</i>	<i>100.0%</i>	<i>100.0%</i>	<i>100.0%</i>	<i>100.0%</i>

Comments: Various factors affect the trends in operating expenditures by chapter. Ideally, the trend would reflect the demand for services from the local citizens and business community. In the case of Romania this is only partly true. Annually in the State budget the expenditure responsibilities of the local and judet councils are modified. In some cases, entire categories of expenditures are added or removed. This distorts the meaning of the trends. However, the trends can still provide valuable insights. In the examples above, expenditures for public and works and housing have grown from one-third to two-thirds of the total. This is a huge change. At the same time, the relative share of general administration expenditures has doubled. This is a sign that the cost of running the local government has gone up. If the data on expenditures by type, that is personnel or materials and services were available, it would show what is driving the increases by chapter. Has the local or judet council hired more people? Or are subsidies increasing rapidly? All this helps interpret the changes in patterns of expenditures.

**Adjusting for inflation**

You may want to look at your financial results in **nominal** and **real** values. Inflation distorts the analysis of financial data over more than one year. When there is inflation the value of the currency, the *leu*, is constantly changing. You could buy much more with a 1994 *leu* than you can in 1999. This makes it difficult to

compare the financial results of one year with those of another. The data included in the local financial reports is expressed in the current value of the *leu* for each year. This is the ***nominal value***.

It is possible through a simple calculation to develop an index of the cumulative effect of inflation. The index will have a base year that provides the initial value of the *leu*. If you know the rate of inflation in each year,<sup>1</sup> you can develop a factor to adjust the value of the *leu* in each year so that it remains constant with regard to the base year. This would look as follows:

	Base Year 1996	1997	1998	1999
Inflation	56.9%	151.4%	40.3%	45.0%
Index	1	1.57	3.94	5.53
Nominal Value	1000	1000	1000	1000
Real value	1000	637	162	29

This table shows, for example, that 29 1996 *lei* are equivalent in value to 1000 1999 *lei*.

The use of real values is especially relevant when looking at trends. For example, revenues or expenditures will appear to be growing rapidly using nominal values. The analysis in real values may show that some categories of revenues or expenditures actually have decreased. This is the case in the value of local taxes and fees from 1994 to 1997 in many localities. Although in nominal terms they appear to be increasing, the analysis in real values shows a constant decreasing trend. This reflects the limitations imposed by the Law on Local Taxes on the ability of the local councils to adjust the tax base and tax rates for inflation.

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<sup>1</sup> There are complex issues regarding the proper measure of inflation to use in converting the local financial data from nominal to real values. However, the discussions of these issues is beyond the scope of this guide.

## PART IV

### PROJECT YOUR FINANCIAL CONDITION

#### Key Concepts and Terms Defined in Part IV

- Policy and economic variables
- Scenarios
- Statement of financial policies

The process of preparing a projection of the finances of the local or judet council consists of two distinct pieces. The first is a forecast of the evolution of revenues and expenditures under different sets of assumptions regarding key ***policy and economic variables*** that largely are outside the control of the local authorities. The second piece is the forecast of the impact of certain policies adopted by the local or judet council to guide its future financial management decisions. As both sets of assumptions affect the future financial results, it is necessary to harmonize the two through an iterative process.

The projection should cover more than one year. Two is probably the minimum. More than three becomes very imprecise given the great uncertainty about future conditions. So, your projection should cover two to three years.

#### ***Look at alternative scenarios***

All sets of projections are guesses about the future. You should not expect to make a correct guess. Rather, you should try to look at different sets of projections. Some should assume that things will go well. Others should look at what happens when things do not go well. For example, your projection might include assumptions for high, moderate and low revenue growth. It also might include assumptions for high, moderate and low growth in expenditures. This produces nine possible scenarios, based on the combinations of revenues growth and cost trends, as follows:

- A. High Revenue Growth – Low Cost Trend
- B. High Revenue Growth – Moderate Cost Trend
- C. High Revenue Growth – High Cost Trend
  
- D. Moderate Revenue Growth – Low Cost Trend

- E. Moderate Revenue Growth – Moderate Cost Trend
- F. Moderate Revenue Growth – High Cost Trend
  
- G. Low Revenue Growth – Low Cost Trend
- H. Low Revenue Growth – Moderate Cost Trend
- I. Low Revenue Growth – High Cost Trend

Calculating all nine would be an enormous amount of work. You may want to focus only on the results of scenarios A., E. and I., that is, those that correspond to an optimistic, moderate and pessimistic set of the assumptions.

### ***Policy and Economic Scenario Assumptions***

The following are some issues that you might want to consider in preparing the projections based on policy and economic variables.

#### *Current revenues*

- The implementation of the new Law on Local Public Finances modified the types and structure of revenues of the local and judet councils. Up to 1998, the local and judet councils received general transfers from the State budget and state operating subsidies for heating and transport, as well as transfers for investments. Starting in 1999, all three were replaced by a single source of revenue, the share of the wage tax. In 2000 this will change to a share of the revenues from the new income tax. In the State budget for 1999, the share for local councils was set at 35 percent of the wage tax. The share for judet councils was set at 15 percent. In both cases, the share can be modified in each annual State budget law. You should consider what impact these changes might have on your local or judet council in future years. What happens if your share increases? What if it declines? What will be the effect of the implementation of the income tax?
- The level of revenues that the local and judet councils will receive from their share of national taxes also will vary depending on the overall performance of the economy. Will wages and income in general grow faster than inflation in the future? Will they lag behind inflation?
- The Law on Local Public Finances also includes provisions for an equalization grant. The formula and criteria to distribute the funds, as well as the overall

amount to be allocated for the equalization grant may vary over time. Will you qualify to receive an equalization grant? How much would you expect to receive?

- Finally, the performance of the economy in your own community now has a major impact on your revenues. You share in the wage taxes paid by local firms and employers. Are jobs growing, stable or declining? Who are the major employers in your area? What are their prospects? Firms also are major local tax payers. The amount they pay in property taxes will change depending on whether they are expanding or closing down their operations. What about new investment that adds jobs and generates assets that are taxable?

### *Operating expenditures*

- The costs incurred by the local and judet councils in providing basic services to the community will vary with the real change in the price of labor and materials, as well as in the price of those services contracted with outside firms. This largely reflects the behavior of prices in the economy in general. If materials and services are an important component of your costs, what would happen if they were to increase faster than inflation? If wages of public employees begin to recover the losses of recent years, how would that affect your overall costs of personnel?
- Another factor that will affect the cost of services is the policy on subsidies to the local population, such as those provided for heating and transport. The experience with heating subsidies in recent years should demonstrate what a huge impact this can have on local finances.
- Together these factors will determine the trend in the overall growth of the operating expenditures of the local or judet council, independent of any decision by the local authorities to increase or decrease the quantity or quality of the services it provides. The assumptions on the real change in the price of labor, materials and services and on the policy on subsidies should vary in each of the expenditure growth scenarios.

The following table provides an example of what a full set of economic and policy assumptions might look like. This example is very complex. You can achieve useful results with much simpler assumptions.

### Policy and Economic Assumptions by Scenario

	Scenario		
	Low	Moderate	High
<b>Policy Variables</b>	Percent of Total Revenues Allocated to Local Councils – All three years		
Share of wage tax	30%	35%	40%
<b>Economic Variables</b>	Percent change relative to inflation – All three years		
Local Fees & Taxes	98%	100%	103%
Wages – general	90%	95%	103%
Wages – local	85%	95%	101%
Materials	101%	103%	105%
Services	101%	103%	105%

### Local policy scenario assumptions

The next step is to prepare a projection that reflects local needs and priorities. One way to do this is to prepare a **statement of financial policies** to guide the local budget and financial management decisions over the period of the projection.

The following table provides an example of typical financial policies for a local or judet council in Romania. Note that these are examples. You should feel free to change to suit the conditions and policies of your own council.

### Example of Financial Policies



Subject Area	Policy Statement
<i>Revenues</i>	<ul style="list-style-type: none"> <li>! Adjust the rates for local taxes and fees annually for inflation</li> <li>! Establish user fees at a level to recover the cost of services</li> <li>! Institute special user fees to finance the cost of services requested only by a part of local citizens</li> <li>! Act promptly to address any delinquency in the collection of local taxes and fees</li> <li>! Develop public/private partnerships in the delivery of basic services and in funding required investments</li> <li>! Manage the assets of the Municipality efficiently</li> </ul>
<i>Expenditures</i>	<ul style="list-style-type: none"> <li>! Maintain current expenditures at a level that will not exceed 60 percent of total expenditures</li> <li>! Maintain capital expenditures at a level that will be no less than 30 percent of total expenditures</li> <li>! Prioritize investment projects, with the highest priority given to investments in infrastructure</li> <li>! Authorize a one-time increase of 10 percent in total local employees in 1999 to administer local taxes and fees</li> <li>! Maintain current levels of service in health and social assistance</li> <li>! Increase expenditures in education by 10 percent per year</li> <li>! Decrease expenditures in public works by 10 percent</li> <li>! Reduce the number of public works employees by 9 percent by mechanizing operations</li> </ul>
<i>Reserves</i>	<ul style="list-style-type: none"> <li>! Maintain a contingency fund equivalent to 4 percent of total revenues</li> <li>! Maintain a revolving fund equivalent to 10 percent of current revenues</li> </ul>
<i>Debt</i>	<ul style="list-style-type: none"> <li>! Maintain a debt service ratio of 7 percent or less of current revenues</li> <li>! Maintain a debt service reserve fund of no less than 10 percent of current revenues</li> </ul>
<i>Financial management</i>	<ul style="list-style-type: none"> <li>! Implement a formal quarterly review of revenues and expenditures</li> <li>! Centralize all procurement</li> </ul>

When you apply these policies to the projections you prepared based on economic and policy assumptions, it may become apparent that not all the proposed policies are viable. This will be true especially in the case of



expenditures under the scenarios where expenditures are growing quickly based on economic conditions. This actually provides an opportunity to look at what your local and judet council would do should actual events follow the assumptions made for these scenarios. This allows to prepare alternative courses of action that preserve local priorities even under difficult conditions. The following table provides an example of the adjustments you might have to make.

### Examples of Adjustments to Financial Policies by Scenario

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*Scenario E: Moderate Revenue Growth / Moderate Cost Trend*

<i>Expenditures</i>	!	Increase the maximum ratio of current to total expenditures from 60 to 65 percent
<i>Reserves</i>	!	Maintain a revolving fund equivalent to 5 percent of current revenues, down from 10 percent

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*Scenario I: Low Revenue Growth / High Cost Trend*

<i>Expenditures</i>	!	Increase the maximum ratio of current to total expenditures from 60 to 70 percent
	!	Reduce the ratio of investments to total expenditures from 30 to 25 percent
	!	Implement a one-time increase in 1999 of 10 percent in the level of expenditures for education
	!	Maintain constant costs in all services starting in 2000 (no increase for inflation), except for education which would begin in 2001
<i>Reserves</i>	!	Maintain a revolving fund equivalent to 5 percent of current revenues, down from 10 percent

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### Addressing inflation in your assumptions

When you prepare your projections you will have to decide how you want to deal with inflation in future years. You have two options. The first is to prepare all the projections without taking into account future inflation. The second is to make assumptions about future inflation in each of the years of your projection. The first option simplifies the calculations. In effect, it presents all your data in real terms using the value of the *leu* in the current year as the base year. Some of the persons who will be reviewing the projections may find this approach

confusing, as they are accustomed to seeing yearly changes in values due to inflation. They may prefer the second option which shows the projections in estimated nominal values for each of the years included in the projection.<sup>2</sup>

You may select either one. Just make sure to be consistent. Apply the same approach to all the numbers in your projection. You cannot have some real and some nominal values. If you decide to prepare the projection in nominal (inflated /e/), the Ministry of Finance probably can provide estimates of inflation at least for the next year.

### ***Performing the calculations***

This discussion is designed to help you in preparing the calculations for each of the financial scenarios for your own local or judet council. It uses the concept and terms defined earlier in this part of the guide, so you may want to review that material first.

Information you will need to get started:

- 8 Base year financial data — Income and expense information for your local or judet council for the most recent year for which you have actual end of year information or the budget figures for the current year. You may use either.
- 8 Economic and policy assumptions — See the section entitled ***Policy and Economic Scenario Assumptions***
- 8 Statement of financial policies — See the section entitled ***Local Policy Scenario Assumptions***
- 8 Inflation assumptions — See the section entitled ***Addressing Inflation in Your Projections***

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<sup>2</sup> For a definition of ***real*** and ***nominal values***, please refer to the section entitled ***Adjusting for Inflation*** in Part III of this guide.



The revenue projections would look at follows:

Example: Projection of revenues from the local taxes for year one of the projection under the pessimistic scenario. The data is from Table 2. The

assumptions are those described in the examples provided in this part of the guide.

Base Data	Economic Assumption	Local Policy Assumptions	Future Inflation	Result Year 1
A	B	C	D	E
Actual taxes collected in the base year	Growth of the tax base relative to inflation	Annual adjustment of the tax base for prior year inflation	1 or 1 plus the projected rate of inflation	$A \times B \times C \times D$
32,700,300	.98	1.00	1.00	32,046,294
32,700,300	.98	1.00	1.45	46,467,126

Note: The values in column E are the same in economic terms. The ending value in the first row (32,046,294) is in real *lei* of the base year, for example 1999. The value in the second row (46,467,126) is in nominal *lei* of the first year of the projection, for example 2000. It assumes that inflation in that year will be 45 percent. Note also that in this scenario you have assumed that the real value of local taxes will decline in year 1 of the projection.

The calculation for year two of the projection is exactly the same, except that the ending value in column E becomes the starting value in column A. If you want you can use different assumptions for year two. This might be useful, for example, if you think the economy will improve or grow worse. This will also complicate the task of preparing the scenarios. You would repeat the process for as many years as you have included in the projection. You also would repeat the process once for all the years using the assumptions for the moderate scenario and once again using the assumptions for the optimistic scenario.

The expenditure projections would look as follows:

Example: Projection of operating expenditures for Public Works and Housing for year one of the projection under the moderate scenario. The data is from Table 2. The assumptions are those described in the examples provided in this part of the guide.



Base Data	Economic Assumption	Local Policy Assumptions	Future Inflation	Result Year 1
A	B	C	D	E
Actual expenditures in the base	Growth of in costs relative to inflation	Increase / decrease in level of services	1 or 1 plus the projected rate of inflation	A x B x C x D
42,832,707	1.03	.90	1.00	39,705,919
42,832,707	1.03	.90	1.45	57,573,583

Once again, the values in column E in the two rows are the same in economic terms. Note also that the assumption regarding inflation is the same as in the example on local taxes. It is important to use the same assumption throughout. The local policy assumption shows a decrease of 10 percent in the level of services. This offsets the growth in of 3 percent in the costs of delivering services. The end result is a decrease in the volume of expenditures in real value. The calculation of the remaining years of the projection and of the values for the other two scenarios would be as described in the example on local taxes.

### ***An alternative method of calculating the projections***

There are other ways to prepare the projections of both revenues and expenditures. Table 4 is an example of a such a methodology. Note that in the case of revenues it uses separate assumptions for the tax base (the value you tax) and the tax rate (the amount of the tax you assess). For expenditures the methodology in Table 4 uses separate assumptions for each of the cost components, that is, personnel, materials & services and subsidies. This approach is useful because it follows more closely the type of decisions you make in the budget process. Obviously, the approach also is much more complicated and difficult.

You might want to use this approach selectively. For example, you could apply the methodology in Table 4 only for property taxes or for the chapter in which you have the highest expenditures, such as public works. For the rest you could use the simpler approach described in the examples above. As long as the approach you take regarding future inflation is consistent throughout, there is no problem in mixing the simpler and more complicated method of calculating the projections.

**Table 4**  
**A Methodology for Preparing Financial Scenarios**

Scenario Assumptions			
	Item to be Projected	Base Data and Output Value	Projection Assumptions
	<b>Recurring Revenues</b>		
	<i>Local Taxes and Fees</i>		
	<i>Of which:</i>		
01.02.	Tax on Profits of Regii	Tax/fee revenues	Ad hoc calculation based on corporatization of regia(ii)
03.02.0 1	Taxes on Self-Employed Professionals and Tradesmen	Tax/fee revenues	Percent change relative to inflation measured in constant lei
03.02.0 2	Property Taxes on Land & Buildings Owned by Individuals	Rate	Percent change relative to inflation measured in constant lei



### Scenario Assumptions

		Tax Base	Percent increase (decrease)
03.02.0 3	Taxes on Personal Vehicles	Rate	Percent change relative to inflation measured in constant lei
	Tax on Personal Income, other than from wages (1998>)	Tax Base	Percent increase (decrease)
03.02.0 4	Notary Fees on Personal Transactions	Tax/fee revenues	Percent change relative to inflation measured in constant lei
		Tax/fee revenues	Percent change relative to inflation measured in constant lei
03.02.3 0	Other Personal Taxes and Fees	Tax/fee revenues	Percent change relative to inflation measured in constant lei
04.02.	Fees for Use of State Property	Tax/fee revenues	Percent change relative to inflation measured in constant lei
05.02.	Corporate Property Tax	Rate	Percent change relative to inflation measured in constant lei
		Tax Base	Percent increase (decrease)
06.02.	Corporate Vehicle Fees	Rate	Percent change relative to inflation measured in constant lei
		Tax Base	Percent increase (decrease)
08.02.	Other Direct Taxes	Tax/fee revenues	Percent change relative to inflation measured in constant lei
15.02.	Entertainment Fees	Tax/fee revenues	Percent change relative to inflation measured in constant lei
17.02.	Other Indirect Taxes	Tax/fee revenues	Percent change relative to inflation measured in constant lei



### Scenario Assumptions

21.02.0 6	Driving Exam & License Fees	Tax/fee revenues	Percent change relative to inflation measured in constant lei
	<i>Shared National Tax Revenues/New Law</i>	Percent share	Assumption on share of wage taxes given to local council
		Wages	Percent change relative to inflation measured in constant lei
		Wages	Wage index with base year = 1
	<i>Equalization grant/New Law</i>	Total amount	Percent equalization
	<i>State Operating Subsidies</i>	Total amount	Ad hoc calculation based on assumption of future subsidy policies

### Operating Expenditures by Chapter

Of which:

*General Administration, of which related to:*

– Current Obligations	Personnel	Percent change relative to inflation measured in constant lei
	Materials/Services	Percent change relative to inflation measured in constant lei
– Changes based on new initiatives/ new legislation	Personnel	Cost of new personnel
	Materials/Services	New expenditures for materials and services

*Education, of which related to:*

– Current Obligations	Materials/Services	Percent change relative to inflation measured in constant lei
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### Scenario Assumptions

– Changes based on new initiatives/ new legislation	New Expenditures	New expenditures for materials and services
<i>Health, of which related to:</i>		
– Current Obligations	Materials/Services	Percent change relative to inflation measured in constant lei
– Changes based on new initiatives/ new legislation	New Expenditures	New expenditures for materials and services
<i>Culture &amp; Sports, of which related to:</i>		
– Current Obligations	Transfers	Percent change relative to inflation measured in constant lei
– Changes based on new initiatives/ new legislation	New Expenditures	New transfers
<i>Social Assistance, of which related to:</i>		
– Current Obligations	Personnel	Percent change relative to inflation measured in constant lei
	Materials/Services	Percent change relative to inflation measured in constant lei
	Subsidies	Percent change relative to inflation measured in constant lei
– Changes based on new initiatives/ new legislation	Personnel	Cost of new personnel
	Materials/Services	New expenditures for materials and services
	Subsidies	New subsidies
<i>Public Works &amp; Housing, of which related to:</i>		

### Scenario Assumptions

– Current Obligations	Personnel	Percent change relative to inflation measured in constant lei
	Materials/Services	Percent change relative to inflation measured in constant lei
	Subsidies	Percent change relative to inflation measured in constant lei
– Changes based on new initiatives/ new legislation	Personnel	Cost of new personnel
	Materials/Services	New expenditures for materials and services
	Subsidies	New subsidies
<i>Transportation &amp; Communication, of which related to:</i>		
– Current Obligations	Subsidies	Percent change relative to inflation measured in constant lei
– Changes based on new initiatives/ new legislation	New Expenditures	New subsidies
<i>Other Economic Activities, of which related to:</i>		
– Current Obligations	Materials/Services	Percent change relative to inflation measured in constant lei
– Changes based on new initiatives/ new legislation	New Expenditures	New expenditures for materials and services
<i>Other Activities, of which related to:</i>		
– Current Obligations	Materials/Services	Percent change relative to inflation measured in constant lei



### Scenario Assumptions

– Changes based on new initiatives/ new legislation	New Expenditures	New expenditures for materials and services
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### Operating Expenditures by Object

*Of which:*

*Total Administrative Expenses, of which related to:*

– Personnel	Total employees	Number Additional (Fewer) Employees
	Wages	Percent change relative to inflation measured in constant lei
– Materials/Services	Total expenditures	Percent change relative to inflation measured in constant lei

*Total Subsidies and Transfers, of which related to:*

– Current Subsidies	Total subsidies	Percent change relative to inflation measured in constant lei
– New subsidies for specific infrastructure services	Total User Fees	Percent to be subsidized based on affordability analysis
– Current Transfers to subordinated institutions	Total transfers	Percent change relative to inflation measured in constant lei
– New Transfers to subordinated institutions	New Expenditures	Net percent to be funded from local budget

### Scenario Calculations

Item to be Projected	Base Data Output Value	Method of Calculation
Recurring Revenues, of which:		(For assumptions, see table Scenario Assumptions)

### Scenario Calculations

#### *Local Taxes and Fees*

*Of which:*

01.02.	Tax on Profits of Regii	Tax/fee revenues	Ad hoc calculation based on corporatization of regia(ii)
03.02.0 1	Taxes on Self-Employed Professionals and Tradesmen	Tax/fee revenues	Prior year x (1+ Assumption (Change))
03.02.0 2	Property Taxes on Land & Buildings Owned by Individuals	Tax/fee revenues	Prior year x (1 + Assumption (Rate)) x (1 + Assumption (Base))
03.02.0 3	Taxes on Personal Vehicles	Tax/fee revenues	Prior year x (1 + Assumption (Rate)) x (1 + Assumption (Base))
03.02.0 4	Notary Fees on Personal Transactions	Tax/fee revenues	Prior year x (1+ Assumption (Change))
	Tax on Personal Income, other than from wages (1998>)	Tax/fee revenues	Prior year x (1+ Assumption (Change))
03.02.3 0	Other Personal Taxes and Fees	Tax/fee revenues	Prior year x (1+ Assumption (Change))
04.02.	Fees for Use of State Property	Tax/fee revenues	Prior year x (1+ Assumption (Change))
05.02.	Corporate Property Tax	Tax/fee revenues	Prior year x (1 + Assumption (Rate)) x (1 + Assumption (Base))
06.02.	Corporate Vehicle Fees	Tax/fee revenues	Prior year x (1 + Assumption (Rate)) x (1 + Assumption (Base))
08.02.	Other Direct Taxes	Tax/fee revenues	Prior year x (1+ Assumption (Change))
15.02.	Entertainment Fees	Tax/fee revenues	Prior year x (1+ Assumption (Change))
17.02.	Other Indirect Taxes	Tax/fee revenues	Prior year x (1+ Assumption (Change))
21.02.0 6	Driving Exam & License Fees	Tax/fee revenues	Prior year x (1+ Assumption (Change))
	<i>Shared National Tax Revenues/Current Law</i>	Tax/fee revenues	Prior year x (1+ Assumption (Change))



### Scenario Calculations

<i>Shared National Tax Revenues/New Law</i>	Tax/fee revenues	Prior year x (Assumption (Share)) x (1 + Assumption (Base))
<i>Equalization grant/New Law</i>	Total amount	See note
<i>State Operating Subsidies</i>	Total amount	Ad hoc calculation based on assumption of future subsidy policies

### Operating Expenditures by Chapter

Of which:

<i>General Administration</i>	Total expenditures	Sum: Personnel+Materials/Services+ New Personnel+New Materials/Services
	Personnel	(Prior year x (1+ Assumption (Change)))
	Materials/Services	(Prior year x (1+ Assumption (Change)))
	New Personnel	New Expenditures Current Year
	New Mat/Services	New Expenditures Current Year
<i>Education</i>	Total expenditures	Sum: Materials/Services+New Materials/Services
	Materials/Services	(Prior year x (1+ Assumption (Change)))
	New Mat/Services	New Expenditures Current Year
<i>Health</i>	Total expenditures	Sum: Materials/Services+New Materials/Services
	Materials/Services	(Prior year x (1+ Assumption (Change)))
	New Mat/Services	New Expenditures Current Year

### Scenario Calculations

<i>Culture &amp; Sports</i>	Total expenditures	Sum: Transfers +New Transfers
	Transfers	(Prior year x (1+ Assumption (Change)))
	New Transfers	New Expenditures Current Year
<i>Social Assistance</i>	Total expenditures	Sum: Personnel+Materials/Services+ Subsidies+New Personnel+New Materials/Services+New Subsidies
	Personnel	(Prior year x (1+ Assumption (Change)))
	Materials/Services	(Prior year x (1+ Assumption (Change)))
	Transfers	(Prior year x (1+ Assumption (Change)))
	New Personnel	New Expenditures Current Year
	New Mat/Services	New Expenditures Current Year
	New Transfers	New Expenditures Current Year
<i>Public Works &amp; Housing</i>	Total expenditures	Sum: Personnel+Materials/Services+ Subsidies+New Personnel+New Materials/Services+New Subsidies
	Personnel	(Prior year x (1+ Assumption (Change)))
	Materials/Services	(Prior year x (1+ Assumption (Change)))
	Subsidies	(Prior year x (1+ Assumption (Change)))



### Scenario Calculations

	New Personnel	New Expenditures Current Year
	New Mat/Services	New Expenditures Current Year
	New Subsidies	New Expenditures Current Year
<i>Transportation &amp; Communication</i>	Total expenditures	Sum: Subsidies+New Subsidies
	Subsidies	(Prior year x (1+ Assumption (Change)))
	New Subsidies	New Expenditures Current Year
<i>Other Economic Activities</i>	Total expenditures	Sum: Current+New Expenditures
	Current expenditures	(Prior year x (1+ Assumption (Change)))
	New expenditures	New Expenditures Current Year
<i>Other Activities</i>	Total expenditures	Sum: Materials/Services+New Expenditures
	Materials/Services	(Prior year x (1+ Assumption (Change)))
	New expenditures	New Expenditures Current Year

### Operating Expenditures by Object

*Of which:*

<i>Total Administrative Expenses, of which related to:</i>	Total expenditures	Expenditures for Personnel + Materials + Services
– Personnel	Total Employees	Prior Employees + Assumption (Change)
	New (Fewer) Employees	
	Average Wage	Prior average x (1 + Assumption (Change))

### Scenario Calculations

	Total Personnel Expenditures	Total Employees x Average Wage
– Materials/Services	Total Material/ Services Expenditures	Prior year x (1+ Assumption (Change))
		Prior year x (1+ Assumption (Change))
<i>Total Subsidies and Transfers, of which related to:</i>	Total expenditures	Subsidies (current) + Subsidies (new) + Transfers (current) + Transfers (new)
– Current Subsidies	Total subsidies (current)	(Prior year x (1+ Assumption (Change)))
– New subsidies for specific infrastructure services	Total subsidies (new)	User fees x (1 + Assumption (Subsidized))
– Current Transfers to subordinated institutions	Total transfers (current)	(Prior year x (1+ Assumption (Change)))
– New Transfers to subordinated institutions	Total transfers (new)	(New Expenditures x (1 + Assumption (Share)))





## PART V

### ANALYZE YOUR INVESTMENT NEEDS AND PRIORITIES

#### Key Concepts and Terms Defined in Part V

- Capital investment plan (CIP)
- General obligation financing
- Project financing
- Project financial analysis

***How do I decide what specific project(s) I will want to finance over the next several years and in what order of priority?***

***Capital investment planning*** is a tool that can help local governments in Romania ensure that decisions on facilities and infrastructure projects and funding are made wisely and are well planned. A Capital Investment Plan (CIP) is a multi-year plan that is produced by a local government that identifies capital projects to be funded during this period. The CIP identifies each proposed project, the year in which it will start and end, the amount (in Lei) expected to be expended on the project and the proposed method of financing the project.

***What are the advantages of preparing a CIP?***

The advantages that a local government can gain from developing a CIP include the following:

- *Provides a comprehensive view of your needs and possibilities.* A basic function of the CIP is to help you look at all your investment needs and financing options together.
- *Helps you prioritize your needs.* A key concern in developing the CIP is to prioritize current and future needs to fit within the financial constraints of the local government. Capital investment planning considers not only what a community needs but, equally important, what it can afford. Developing a CIP is very different than developing a “wish list” of projects that cannot be fully implemented. The CIP puts you in control of all your investment decisions.



### ***How do I explore the options available to finance priority projects?***

There are various sources of financing to consider:

- 8 The revenues of the local and judet council that remain after paying for local operating expenses
- 8 Borrowing backed by the revenues of the local or judet council itself
- 8 Special programs of the Government of Romania or of foreign donors
- 8 Fees paid by the local consumers of services provided by the local or judet council directly or through a local *regia*, such as those for water, heating or public transport
- 8 Borrowing backed by the fees paid for services

The two options that involve financing with revenues of the local or judet council are those that are the subject of this document. In the case of such financing, any project that is of local interest can be financed. This often is referred to as ***general obligation financing***. The analysis of the debt carrying capacity of the local or judet council will determine how much financing is available from this source.

In the case of special programs of the Government or of foreign donors the amount of financing that might be available and the projects that are eligible will be determined by the rules and procedures of the programs.

Financing provided from the fees paid for specific services or from debt backed by those fees will be limited to financing projects related exclusively to that service. This often is referred to as ***project financing***. The technique involved in determining whether and how to finance from the fees generated by a project itself is called ***project financial analysis***.

### ***How does project financial analysis work?***

It is beyond the scope of this document to explain in detail how this is done. The following is a short summary of the process.

In preparing a project financial analysis you need to consider the following elements, among others:

- 8 Make sure you have complete estimates of the cost of the project and of the subsequent costs for operation and maintenance of the completed project. If there is more than one technical option (e.g. rehabilitation versus replacement) consider the impact of each option on the financial feasibility of the project. Also, try to determine if the size of the project is consistent with the expected demand or need. A project that is over dimensioned might not be feasible, but if it is redesigned to focus more narrowly on the need or demand it might be feasible.
- 8 Consider very carefully how much you can really charge for the service that the project will provide once it has been completed. Be careful not to assume that you will be able to charge whatever level fee is necessary to ensure that the project is self-financing. Look at increases in other local taxes and fees that will have an impact on the households and businesses in your community. Take into account that not everyone will pay on time or at all. Also, there may be laws or regulations that limit your authority to set the fee for specific services.
- 8 Look for possible savings in the current operating and maintenance costs of the *regia* or other local company that manage local services. You may be able to free up part of their current revenues to finance at least part of the cost of the project.

### ***What happens if there are insufficient resources to finance all the projects?***

It is very likely that the possible avenues of financing fall far short of the total cost of the projects presented for consideration in the CIP. In order to figure out which projects you will actually want to fund within the limits of available sources you need to compare the projects one with another using a set of criteria that measure their impact on the community. The objective is to list the projects in order of priority, starting with those that have the highest priority.

Once you have listed your projects in order of priority, you can assign funding to them to the extent of the resources available to you. In this manner, the highest priority projects, that is, those that address the most important community needs are funded first. For purposes of this document, the focus is on those projects that are not fully self-financing. They will require financing from the revenues of



the local or judet council itself or from debt backed by those revenues. The list of these projects in order of priority is an important element of the process of determining your debt carrying capacity.



## PART VI

### DECIDE WHETHER AND HOW MUCH TO BORROW

At this point, you should have at least three scenarios that look at your finances over a period of three to four years. You also should have a prioritized list of those investment projects that are not fully self-financing and will require financing from the revenues of the local or judet council itself or from debt backed by those revenues. Now you are ready to determine your debt carrying capacity and to decide whether and how much you want to borrow.

The remaining steps are to:

- 8 Analyze your projected net operating results
- 8 Introduce assumptions on possible loans into your scenarios
- 8 Adjust the scenarios as needed
- 8 Decide whether and how much to borrow

**Analyze your projected net operating results.** In its simplest expression, the debt carrying capacity of the local or judet council is determined by how much you can set aside from your recurring revenues each year over the next several years in order to make annual debt service payments. Since any projection is uncertain, you want to plan your borrowing so that the annual debt service is less than the projected operating surplus over the life of the loan.

The projections of your finances in the three scenarios should give you an idea of what your operating results might be under different assumptions about growth in revenues and expenditures. First, you need to address those scenarios in which you anticipate an operating deficit in one or more of the years of the projections. An operating deficit shows that you cannot pay for the services you plan to provide to your community with recurring or current revenues. You should understand and address the causes of the deficit before proceeding with the analysis of your debt carrying capacity. This may require measures to increase your current revenues, decrease your operating expenditures or some combination of the two.

**A note of caution** If you anticipate that you may have an operating deficit at some point in the future, you should defer any decision to borrow until you have analyzed and addressed the causes. If this deficit were to persist for more than one year in the near future, you could be facing serious financial problems.

**Introduce assumptions on possible loans into your scenarios.** Once you have adjusted your three scenarios so that they all include an operating surplus, the next step is to add assumptions about possible loans. From the prioritized list of projects that require financing from the local or judet council itself you should be able to make a preliminary determination of the size of the loan. The local bankers should be able to give you an idea of the possible terms under which you might be able to borrow, if you do not already have this information from other sources. That will give you an estimated debt service that you can introduce in each of the financial projections. At this point you should use the same loan assumptions in all three scenarios.

**Adjust the scenarios as needed.** If the projected debt service exceeds the projected operating surplus in one or more of the scenarios, you will have to make further adjustments. You can introduce further measures to increase your current revenues, decrease your operating expenditures or some combination of the two. Or, you can reduce the amount of the loan. In effect, through the scenarios you have developed you will be anticipating the difficult choices that you may have to make between paying for services and investing in new projects. Largely, this is a matter of judgement. It depends on your local priorities and needs. There is no single correct answer. The choices between services and investments always will be present when you make a decision about a loan. It is important to be aware of the choices and to be comfortable with the consequences before proceeding with any loan.

**A note of caution** Be careful about changing any of the assumptions in your scenarios that represent events or variables over which you have no control. For example, you should avoid balancing the scenarios by assuming unrealistic terms on the loan, as these are determined by the credit markets over which you have no control. It is better at this point to be conservative.

**Decide whether and how much to borrow.** If you have completed all the prior steps, at this point you should know the maximum annual debt service that is





affordable in all three scenarios you have created. That is, you know your debt carrying capacity. You also know what impact the proposed level of borrowing will have on the overall service and investment needs of your community.

Now you must decide whether and how much to borrow. You have several options, including the following:

- 8 *Accept the results of the debt carrying capacity analysis* — In this case, you would proceed to seek a loan that does not exceed the maximum annual debt service you have calculated.
- 8 *Conclude that the potential impact and risk of the proposed level of borrowing is not acceptable* — In this case, you might want to seek a smaller loan or try to negotiate terms that reduce the annual debt service..
- 8 *Postpone the decision whether and how much to borrow*— In this case, you would decide that you prefer to wait until future events that could affect your finances unfold and you can assess the risks more accurately.
- 8 *Proceed with a larger loan, despite the results of the analysis* — You may feel that certain projects cannot wait or that you have a unique opportunity to obtain financing that may not be available again in the future. You may also be willing to accept higher risks by betting that the most pessimistic scenario will not become a reality.

Whatever the choice, it is very important that the discussion and review of the options take into account the lessons you have learned from the debt carrying capacity analysis. The elected members of the Local or Judet Council should be aware of the results of the analysis when they debate the issue. The presentation of the analysis to the Council will offer a unique opportunity to discuss broad issues of local interest. What is your current financial condition? What are the factors that might affect your finances in the future? What measures can you take to mitigate risks and to take full advantage of opportunities that might arise in the coming months and years? What are the tradeoffs between your service and investment needs? These insights will be valuable whatever decision you finally make on possible loans to finance investments.



## **PART VII**

### **USE THE RESULTS OF THE ANALYSIS TO MONITOR AND MANAGE YOUR FINANCES**

By preparing scenarios that include all possible variations on the key variables and events that affect your local finances, you can now anticipate what measures you will have to adopt to protect and preserve the interests of your community. You know the risks and have a plan to address them. If you decide to proceed with a loan, you can do so with reasonable confidence in the evaluation of the local debt carrying capacity. It is prudent to anticipate what can go wrong, even if it is unlikely or not very desirable. Conversely, imagine what might happen if the projections had not included the pessimistic assumptions and future events followed the path of those assumptions. The best way to deal with a crisis is to prepare for it.

The process of preparing the debt carrying capacity analysis will help you monitor and manage your finances. You now have a better understanding of your current financial condition. You also know what factors can affect your finances. You have a plan to address problems that might arise.

#### ***What happens after there is a local decision to borrow?***

If the local or judet council decides to proceed with a loan you should apply what you have learned in preparing the debt carrying capacity analysis in every phase of the borrowing process.

When approaching potential lenders:

- 8 Consider preparing a short written presentation that describes your community, its advantages and its needs, the projects you have in mind and how they relate to those needs, your finances and why you believe you are a good risk for an investor or lender. Make the document attractive.
- 8 Show that you have a rational plan to use the funds you will raise through the financing. It is potentially very valuable to show that your community is aware of the plan and supports it.
- 8 Show that you have a sophisticated understanding of your finances. Be positive but do not try to hide your problems. Not everything needs to be perfect. A lender or investor knows that you face certain problems. He will

want to know that you are aware of these problems and that you have a plan to address them.

During the negotiations:

- 8 Remember that your local or judet council is solely responsible for knowing and protecting its own interests. No outside party, public or private, will have those same interests in mind. You have your own estimate of how much you feel you can afford to pay annually for debt service. You also know what projects you want to finance ranked in priority order based on the benefits they bring to your community.
- 8 Ask the lender or investor to explain any terms or conditions in their offer that you do not understand. Consider obtaining advice from experts outside your local or county council if you are not sure you understand or can evaluate the offer.
- 8 If you succeeded in obtaining more than one offer of financing, the terms and conditions may differ from one offer to another. Terms, such as fixed vs. variable rates, loans in different currencies, fees, schedule and conditions of disbursement, and so on, have a direct impact on the total cost to you of a particular offer of financing. If you are not sure how to evaluate such costs, obtain expert advice of your own.

After the loan has been signed:

- 8 Whether you are the borrower or a guarantor, monitor very carefully the progress in time and cost of the project you are financing with the loan. If there are strict conditions regarding the schedule of disbursements there may be penalties to pay for a delay in drawing down the funds. Once you begin to pay interest on the loan, construction delays will be very costly.
- 8 The revenues from the completed project may be required to repay the loan or investment. Delays, or worse yet, a failure to complete the project can have serious consequences. If final costs exceed the original estimates, do you have access to other funds to complete the project?

***What can I do to make sure we will be able to pay the annual debt service on time?***



Monitor the debt service schedule on all your loan portfolio carefully. For the current year, be aware of the dates when payments are due.

Monitor the rest of your budget very carefully.

- 8 Look for expenditures that are higher than expected or for revenues that are lower than expected. Will you have sufficient cash on hand? What will you do if your revenues from taxes or other sources are delayed or are less than you anticipated?
- 8 Look forward to anticipate potential problems. If you have a variable interest loan, how likely is it that interest payments may increase? If you are paying in a foreign currency, how likely is that it may become more expensive for you to buy that currency?
- 8 Have a contingency plan. Determine in advance what other expenditures you can defer if necessary. Consider getting a line of credit with the State Treasury or with a local bank.
- 8 At least once a year, probably when you are preparing the budget for the next year, look three or four years into the future. Consider the same questions as above. Plan what you can do today to minimize future risk and to prepare contingencies for unanticipated problems.

If you are the guarantor, be sure to monitor the performance of the borrower.

- 8 Are they in compliance with all the terms and conditions of the various contracts and agreements?
- 8 Obtain complete and timely information from the borrower so that you can anticipate their ability to meet their future obligations to the lender or investor.
- 8 If there appear to be problems, ask the borrower to take corrective actions in time to avoid triggering your guarantee.